

Brief outline of the regulation concerning FX lending in Hungary

In line with the Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1) Magyar Nemzeti Bank (the central bank of Hungary hereinafter: MNB) hereby provides the main provisions and a list of relevant pieces of regulation on this issue.

Background

The crisis of financial sector in the euro zone led to increased sovereign risks, which in turn brought significant soaring up in risk premiums and contributed to the major appreciation of the CHF against the EUR and even more against HUF. Hungarian households, between 2004 and 2010 indebted mostly in foreign currencies due to the significantly lower interest rates of such mortgages compared to HUF loans, experienced a further increase of their debt burdens in 2011, principally because of the HUF depreciation. In addition, banks increased CHF and EUR interest rates. Dramatically increased instalments caused difficulties for a growing number of debtors in Hungary. In the recent years foreign exchange lending to households has become not only a major problem from a financial consumer protection standpoint, but also a key economic policy, social and public policy issue.

In Hungary, several regulatory measures have been taken to radically cut back the continued growth of retail foreign exchange loans and to treat the problem of excessive FX indebtedness, and implemented in order to make FX lending practice of institutions more prudent.

I. Regulation aiming the restriction of FX lending and the protection of customers

Currently the following provisions are in force in Hungary aiming the protection of customers and the restriction of foreign currency lending activity of financial institutions to unhedged borrowers.

- General restriction on FX lending

Currently financial institutions are allowed to provide loans to natural persons in foreign currency only under very strict conditions. According to the provision of Government Decree 361/2009 on the terms of prudent retail lending and the assessment of creditworthiness, FX mortgage loan can be granted only on condition that the eligible future borrower shall have regular authenticated monthly gross income in the currency of the loan and it is 15 times higher than the statutory minimal monthly basic wage determined for full-time employees prevailing at the time of signature of the credit contract.

- Upper limit on the loan-to-value ratios for retail mortgage loans

According to Government Decree 361/2009 on the terms of prudent retail lending and the assessment of creditworthiness the value of the exposure at the time of the commitment shall not exceed 80% of the property's market value in case of loans denominated in HUF and secured by mortgage on real estate property. Where the loan is provided for a building

under construction, the above-specified percentage shall apply to the market value of the property when fully completed. The limits are 60% in case of mortgage loans denominated in EUR and 65% in case of financial leasing arrangements denominated in EUR while 45% and 50% denominated in other currency, respectively.

In connection with any car loan denominated in HUF, the value of the exposure at the time of the commitment shall not exceed 75% of the car's market value, or 80% in connection with financial leasing arrangements. The relevant limits are 60% or 65% in case of car loans denominated in EUR and 45% or 50% denominated in other currency, respectively.

- Ban on purely collateral based lending

Government Decree 361/2009 on the terms of prudent retail lending and the assessment of creditworthiness requires banks to set up creditworthiness limits for all individual loan applicants defined in proportion to monthly income, i.e. DTI ratio, as well. The assessment of credit eligibility has banned purely collateral based lending and requires the credit eligibility check of private person customers on a mandatory basis in each and every case. The credit eligibility check must be based on the credit eligibility limit derived from the income position of the household concerned. The credit eligibility limit shows the maximum monthly repayment amount which the debtor can safely finance from his/her income. The instalments to be paid in a month at the time of the credit approval may not exceed 80% of the credit eligibility limit in case of loans denominated in EUR and 60% of the credit eligibility limit in case of loans denominated in other currency. When calculating the credit eligibility limit, repayments for the customer's existing borrowings must also be taken account.

- Definition of applicable conversion rates

The applicable conversion rates for FX lending have been determined in the Act CXII of 1996 on credit institutions and financial enterprises. According to the relevant provisions the monthly payable amounts and the costs denominated in a foreign currency shall be calculated by using the institutions' own or the MNB's official middle exchange rates thus protecting consumers from the costs originated from the spread between bid and offer FX rates applied by the banks at different point of times or actions in connection with a specific loan. Those conversion rates shall be applied in case of partial or full early repayment of the loans, as well.

- Other consumer protection type of provisions

According to the general rules of Act CLXII of 2009 on consumer credit, creditors are obliged to provide information to consumers in order to assess whether the credit meets the consumer's needs and financial capabilities. The information shall cover the main characteristics of the credit, the impact of the credit on the financial situation of the consumer and the consequences of default of payment.

In case of foreign currency loans, Act CXII of 1996 on credit institutions and financial enterprises requires lending institutions to expressly specify in the contract the risks to which the clients are exposed including the risks of any fluctuation of exchange rates and monthly payments.

Furthermore, the lending institution shall provide the client with the information whether it has undertaken to be bound by the legally non-binding Code of Conduct, or not. Code of

Conduct collects the generally accepted provisions of retail lending activity applicable on a voluntary basis and is signed by most of the institutions providing loans in Hungary.

Regarding the pricing of foreign exchange based consumer credit and loan contracts, institutions are allowed to charge in a foreign currency only those expenses and fees, which are directly connected to obtaining the foreign currency required to execute and maintain the given contract.

Concluding a mortgage credit contract, institutions shall determine the change in interest rate of the loan either by using a reference interest rate or by fixing the interest rate for a 3-year, 5-year or 10-year interest rate period in the contract. Act CXII of 1996 also specifies that in case of EUR loan and Euro based loans the reference rate is the 3-month, 6-month or 12-month EURIBOR, while in case of CHF loans and CHF based loans the 3-month, 6-month or 12-month CHF LIBOR shall be applied. The law allows the unfavourable change of the interest surcharges only upon non-compliant performance by the customer. The rules of transparent pricing only refer to household mortgage loans concluded after 1 April 2012. The regulation enabled customers with an existing mortgage loan contracts to initiate contract modification by 31 August 2012 in order to switch to the new pricing mechanisms.

Pursuant to legal provisions, institutions must not grant loans to retail clients where the annual percentage rate (APR) exceeds the central bank interest rate plus 24 percentage points.

II. Prudential regulation concerning FX lending

- Capital adequacy

According to Act CXII of 1996 on credit institutions and financial enterprises credit institutions shall have sufficient own funds to cover the risks of its activities including foreign exchange risk, as well.

In the guideline called “Information on high-risk portfolios and on the related additional capital requirement as key priorities in the supervisory review process (SREP)” MNB recommended that all banks should determine the foreign exchange risk related minimum capital requirement on the basis of a standard model (developed by MNB) calculated with data pertaining to the same period.

As Hungary is highly exposed to FX lending, the assessment of the capital requirement for this risk is an integral part of SREP investigations from the very beginning, as a special aspect to take into account, and not as a separate process.

In the case of largest Hungarian banking groups, MNB requires to apply risk sensitive - PD, LGD based – approaches to assess their credit risks. High risk of the FX lending is appropriately reflected through PD, LGD estimations in the pillar 2 capital requirement (and also in the regulatory own funds via EL minus provisions), especially on the un-hedged retail mortgage loans.

MNB also requires the supervised institutions under Pillar 2, as part of their stress testing exercises, to take into account the FX impact on the outstanding FX loan portfolio.

The advised approach is to link FX rate change to the default rate and/or PD time series, but at least separate modelling of the FX dependent portfolios is a requirement.

There is a special regulatory measure to prevent new exposures of certain types by imposing special capital add-on on them, as well. This includes certain FX related credit exposures, e.g. those denominated in JPY, as well.

- *Liquidity*

According to Act CXII of 1996 on credit institutions and financial enterprises credit institutions shall maintain liquidity at all times. Government Decree No. 366/2011 on determining of the level of liquidity of credit institutions and regulation of maturity match in case of foreign currency position requires the application of three ratios: deposit coverage ratio, asset coverage ratio and FX funding adequacy ratio.

The deposit coverage ratio shall be calculated as a quotient of the credit institution's 30 days actual liquidity position and the stock of deposits placed by households and non-financial corporations. The total assets coverage ratio shall be calculated as a quotient of the credit institution's 30 days actual liquidity position and its total assets. Commercial banks shall at all times maintain a deposit coverage ratio higher than 0.2 or an asset coverage ratio higher than 0.1. Mortgage credit institutions shall at all times maintain an asset coverage ratio higher than 0.05.

In order to ensure the maturity match of the foreign exchange position of credit institutions a new minimum foreign exchange funding adequacy ratio came into force as of 1 July 2012. The ratio shall be calculated as a quotient of the foreign currency resources qualified as stable and the stock of net foreign currency swaps against HUF with maturity of more than one year to the founded stable assets in foreign currency and the off balance sheet liabilities in foreign currency. Commercial banks and mortgage credit institutions shall reach at all times at least the level of 0.65 foreign exchange funding adequacy ratio.

III. Regulation treating the problem of excessive FX indebtedness

Several legislative efforts have been initiated to mitigate the aggravating debt burden problem associated with the foreign currency loans of households in Hungary, as well. The primary objective was to assist foreign currency loan debtors and to protect homes. A number of regulations were adopted, concerning among others the final repayment of foreign currency loans at a fixed preferential exchange rate; forced conversion of FX mortgage loans; the government-backed exchange rate fixing scheme; a quota system for foreclosure; the National Asset Management Company and the subsidized interest rates.

- *Government-backed exchange rate cap system*

Act LXXV on fixing the exchange rate of FX loans and on forced foreclosure of collateral properties initiated a government-backed exchange rate cap system, as well.

According to the legislation the debtor is entitled to initiate a contract with the financing institution in order to join the scheme. Institutions shall check the pre-requirements and, a contract will be signed on opening a special account.

Term of the contract on special account shall not be shorter than that of the original FX mortgage contract. Term of the scheme is 60 months ("grace period"). During the grace period the FX mortgage loan is paid by the debtor at a fixed, preferential exchange rate (180 HUF/CHF, 250 HUF/EUR or 2.5 HUF/JPY). The difference between the fixed, preferential rate and the actual market rate is collected on the special account as a HUF loan. Capital part of the HUF loan will be paid by the debtor after the grace period while interest part is paid 50-50% by the financial institution and the central budget. If the HUF exchange rate exceeds 270 HUF/CHF, 340 HUF/EUR or 3.3 HUF/JPY, the exceeding part is paid totally by the central government. Except for the HUF interest rate on the debt collected on the special account, imposing any fees or commissions by the institution is prohibited by the law. The part of the interest to be paid above the fixed rate under this scheme is reimbursed by the state to the lender.

Act CLXXIII of 2013 (entered into force on 9th of November 2013) on amending certain acts to assist FX borrowers abolished most of the original pre-requirements of this scheme in order to broaden the range of eligible borrowers who will be entitled to join exchange rate cap scheme of the exchange rate fixing. The act extends the exchange rate cap facility to those with debts over HUF 20 million and even for those who already participate in other payment easing programs (except those programs that financed by the state). Among others, the act stipulates that the exchange rate cap scheme will be unavailable only for those whose payments are overdue by more than 180 days and it removes the government's guarantee on the offset account if a mortgage was over a 95% LTV.

- *Quota system*

The Government adopted rules regarding the sales of residential real estate collaterals in June 2011. According to the provisions of Act LXXV of 2011 the sales of properties served as collateral are restricted by quarterly quotas with the aim to limit the number of properties sold by the institutions reducing the effect on the prices of real estate market and to limit the number of evicted debtors, as well.

Between 1st October 2011 and 31st December 2014 collateral properties are allowed to be assigned for forced liquidation only if they are marked out under a quota system. The institutions shall set the list of properties for forced sale quarterly separately in each county and in Budapest. According to the quota-system the quotas are gradually increasing (in 2011 2%, in 2012 3%, in 2013 4% and in 2014 5% of the number of mortgage credit agreements past due more than ninety days). From 1 January 2015 all residential real estate collaterals can be sold by the creditors without any restriction. Eviction moratorium has been expanded until 30 April 2014.

- *National Asset Management Agency (NAMA)*

The Government set up the National Asset Management Agency with the aim to socially support of deprived persons having retail mortgage loans denominated in foreign currency. According to the legislation NAMA purchases mortgaged residential properties of deprived debtors, and allows them to stay in the property as tenants. The debtors pay a discounted rental fee, and they can stay in their original apartment, while the lender writes-off the remaining mortgage debt.

- *Subsidized interest rates*

Furthermore, the Government in its Decree No. 341/2011 on housing interest subsidy has launched a Home Creation Programme by providing social housing subsidy and granting interest rate-subsidised forint loans for buying residential properties. Provided certain conditions are fulfilled, subsidies can be applied for the following purposes: building or purchasing a new home; purchasing or refurbishing used home; purchasing a housing property that is encumbered with a defaulted mortgage or terminated loan; for defaulted debtors for purchasing a smaller home; for replacing a defaulted foreign currency mortgage secured with a housing property collateral into a loan denominated in HUF and for purchasing back a housing property from the NAMA.

**List of regulatory tools with FX lending relevance
mapping with ESRB's recommendations¹**

<p>Risk awareness of borrowers</p>	<ul style="list-style-type: none"> • <i>Act LXXV of 2011 (28 June 2011) on the fixing the exchange rate used for the calculation of instruments of foreign exchange denominated mortgage loans and the forced sale of residential properties</i> • <i>Section 203 of Act CXII of 1996 on credit institutions and financial enterprises (statement of risk acknowledgement): engaged in retail lending</i> • <i>Sections 4-17 of Act CLXII of 2009 on consumer credit</i> • <i>Section 3 of Government Decree No. 361/2009 on the terms of prudent retail lending and the assessment of creditworthiness</i> • <i>Government Decree No. 341/2011 on housing interest subsidy</i> • <i>HFSA² Recommendation No. 9/2006 on the principles of providing preliminary advice to clients and consumer protection in relation with retail crediting</i> • <i>HFSA - Recommendation No. 9 of 2006 (XI. 7) of the Board of the Hungarian Financial Supervisory Authority</i> • <i>HFSA Recommendation No. 1/2011 on the principles of consumer protection expected from financial organisations</i> • <i>Recommendation issued jointly by Magyar Nemzeti Bank (the central bank of Hungary (MNB)) and HFSA on the systemic risks of foreign currency lending and institutional and consumer protection requirements relating to the prudent assessment and management of such risks, with special regard to Japanese yen-based lending</i> • <i>Code of Conduct on principles of fair conduct by financial organizations engaged in retail lending</i> • <i>Dear CEO letter No. 7/2009 on the behaviour expected from credit institutions with regard to the mitigation of client burdens arising from the repayment of foreign currency loans</i> • <i>Dear CEO letter No. 8/2009 on the information to be provided to the clients in the case of changes in the repayment of foreign currency loans</i> • <i>Dear CEO letter No. 1/2011 on the conversion of CHF based loans to EUR based loans</i>
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¹ The list contains both legally binding acts/decrees and non-bind regulatory tools, i.e. guidelines recommendations, Dear CEO letters, Code of Conduct, methodological guideline.

² HFSA: the former Hungarian Financial Supervisory Authority,

Creditworthiness of borrowers	<ul style="list-style-type: none"> • <i>Act No. CXXII of 2011 on central credit information registry</i> • <i>Government Decree No. 361/2009 on the terms of prudent retail lending and the assessment of creditworthiness</i>
Credit growth induced by foreign currency lending	<ul style="list-style-type: none"> • <i>Act LXXV of 2011 on the fixing of the exchange rates used for the calculation of instruments of foreign exchange denominated mortgage loans and the forced sales procedure of residential properties</i> • <i>Government Decree No. 361/2009 on the terms of prudent retail lending and the assessment of creditworthiness</i> • <i>Section 171 k) of Act CXXXIX of 2013 on MNB</i> • <i>ICAAP-SREP Guidelines of MNB</i>
Internal risk management	<ul style="list-style-type: none"> • <i>Sections 13/D, 76/K, 153, 210 and 210/B of Act CXII of 1996 on credit institutions and financial enterprises</i> • <i>Government Decree No. 361/2009 on the terms of prudent retail lending and the assessment of creditworthiness</i> • <i>Recommendation issued jointly by MNB and HFSA on the systemic risks of foreign currency lending and institutional and consumer protection requirements relating to the prudent assessment and management of such risks, with special regard to Japanese yen-based lending</i> • <i>ICAAP-SREP Guidelines of MNB</i> • <i>HFSA Recommendation No. 8/2001 on credit risk management</i> • <i>HFSA Recommendation No. 7/2006 on increasing the effectiveness of credit risk management</i>
Capital requirements	<ul style="list-style-type: none"> • <i>Section 76 (1) a) 3) and 145/A of Act CXII of 1996 on credit institutions and financial enterprises</i> • <i>ICAAP-SREP Guidelines of MNB</i>
Liquidity and funding	<ul style="list-style-type: none"> • <i>Sections 89, 144 and 145/A d) and (2a) of Act CXII of 1996 on credit institutions and financial enterprises</i> • <i>Government Decree No. 366/2011. on determining of the level of liquidity of credit institutions and regulation of maturity match in case of foreign currency position: rules on deposit and total assets coverage ratios and on foreign exchange funding adequacy ratio</i> • <i>Methodological Guideline No. 6/2010 on the measurement and management of liquidity risk</i> • <i>ICAAP-SREP Guidelines of MNB</i>

Reciprocity	<ul style="list-style-type: none">• <i>Section 13/D, 32/A, D-H, 90, 96/B of Act CXII of 1996 on credit institutions and financial enterprises relevant modification</i>• <i>MNB website: Informative Guide to laws and other legal provisions regulating the financial service sector in Hungary</i>• <i>MNB website: List of Consumer protection oriented provisions</i>
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